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ASB meeting minutes, 2005, April 26-28

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AUDITING STANDARDS BOARD (ASB) MEETING
April 26-28, 2005
New York, NY

MEETING ATTENDANCE

ASB Members

John Fogarty, Chair
Harold Monk, Jr., Vice Chair
Barton Baldwin
Gerry Burns
George Fritz
Jim Goad
Dan Goldwasser
Lyn Graham
Jim Lee
Wanda Lorenz
Bill Messier
Dan Montgomery
Keith Newton
George Rippey
Lisa Ritter
Diane Rubin (except Thursday)
Darrel Schubert
Scott Seasock
Mike Umscheid

AICPA Staff

Chuck Landes, Director, Audit and Attest Standards
Ahava Goldman, Technical Manager, Audit and Attest Standards
Mike Glynn, Technical Manager, Audit and Attest Standards
Hiram Hasty, Technical Manager, Audit and Attest Standards
Dionne McNamee, Technical Manager, Audit and Attest Standards
Judith Sherinsky, Technical Manager, Audit and Attest Standards
Sharon Walker, Technical Manager, Audit and Attest Standards

Guests

Darrel Schubert, *Ernst & Young LLP*
Marcia Buchanan, *Government Accountability Office*
Julie Anne Dilley, *PriceWaterhouseCoopers LLP*
Bob Dohrer, *McGladrey & Pullen LLP*
Diane Hardesty, *Ernst & Young LLP*

Len Jui, *US Securities and Exchange Commission*
Maria Manasses, *Grant Thornton*
Tania Sergott, *Deloitte & Touche*
Mary Ann White, *PPC*

AGENDA ITEMS PRESENTED AT MEETING

1. Proposed SAS: Sarbanes-Oxley Omnibus SAS

The ASB voted to withdraw Proposed Statement on Auditing Standards, *Sarbanes-Oxley Omnibus Statement on Auditing Standards*.

2. Risk Assessment

Mr. Darrel Schubert, chair of the Risk Assessments Task Force (task force), an ASB continuation of the joint project of the International Auditing and Assurance Standards Board (IAASB) and the ASB led a discussion of the status of the risk assessment project.

Mr. Schubert reported that the risk assessment task force met on February 23, 2005 and March 9, 2005 (via conference call) to: 1) conform the *Planning and Supervision* exposure draft to ISA 300, *Planning an Audit of Financial Statements*; 2) follow up on the ASB directives relative to the *Audit Risk and Materiality* exposure draft; and 3) finalize the other exposure drafts.

Mr. Schubert reported the significant issues discussed by the task force and the significant revisions made to the proposed standards.

Significant Issues

a. *Known vs. Likely*—Paragraph 58 of the revised *Audit Risk and Materiality* exposure draft states “The auditor would compare the point estimate to the amount recorded by the client and include any difference in the aggregation of known misstatements. The task force disagrees with this conclusion. It is the task force’s position that audit differences involving accounting estimates should be classified as likely misstatements in evaluating uncorrected misstatements. This is because the auditor’s procedures to assess the reasonableness of management’s estimates may be imprecise; and therefore, the illogical consequence of this requirement would be to force the auditor’s amount (unless it is precisely determined by the auditor), which is less precise than management’s to be reflected in the financial statements.

After discussion, the ASB: i) concluded that audit differences involving accounting estimates should be classified as likely; ii) determined that paragraph 58 of the draft be deleted since it is no longer necessary; iii) directed the staff to include a comment on this issue in the comment letter to the IAASB on proposed ISA 320; and iv) highlight this difference between the proposed SAS and proposed ISA 320 in the explanatory memorandum to the exposure draft.

b. “Rollover” vs. “Iron Curtain”—Paragraph 53 of the *Audit Risk and Materiality* exposure draft discusses the requirement that the auditor should consider the effect of misstatements related to prior periods. This content was taken from ISA 320. The task force’s interpretation of this paragraph, as written by the IAASB, would require the auditor to consider both the ‘iron curtain’ and the ‘rollover’ methods in evaluating audit findings, and correct any individual material misstatement resulting from either method (the ‘rollover’ method considers the aggregate effect of prior period and current period uncorrected misstatements, while the ‘iron curtain’ method only considers the cumulative effect of the uncorrected misstatements).

After discussion, the ASB resolved to proceed with guidance, as amended by the Board, that would require the auditor to evaluate uncorrected misstatements related to prior periods and directed the staff to highlight this issue in the explanatory memorandum to the exposure draft to solicit comments on this issue.

Mr. Schubert then discussed the significant revisions made to the draft standards since the last meeting. The most significant revisions were made to the Planning and Supervision exposure draft to conform it to ISA 300 and to the Audit Risk and Materiality exposure draft to follow up on comments received from the ASB in February 2005.

There was discussion regarding the reference of the term ‘reasonable assurance’ as a ‘high level of assurance.’ After discussion, the ASB concluded that the change in definition of the term reasonable assurance should be made to SAS No.1, *Codification of Auditing Standards and Procedures, Due Professional Care in the Performance of Work*, and the amendment to SAS No. 1 should be included in the suite of proposed standards.

Following the discussion of the significant issues and the significant revisions to the exposure drafts, the ASB voted in favor of a ballot vote to re-issue the suite of proposed standards, including the amendment to SAS No. 1, for exposure for a period of 60 days.

3. Group Audits

Ms. Rubin, chair of the Group Audits task force, led a discussion of Proposed (Revised) ISA 600, *The Audit of Group Financial Statements*. The task force is charged with revising SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 543, "Part of Audit Performed by Other Independent Auditors"), as amended. Ms. Rubin noted that the most significant issue for the U.S. is the elimination in the proposed ISA of the option to divide responsibility.

The ASB directed the task force to:

- Retain division of responsibility in the U.S. and to reaffirm in our comment letter to the IAASB that we believe that division of responsibility is an appropriate alternative to full responsibility, so that absence of comment would not be taken as assent;
- Include in the comment letter the ASB’s belief that the proposed requirements on access to information will lead to difficulty that may result in the group auditor

disclaiming, withdrawing from or not accepting engagements, since the option of division of responsibility is not available;

- Consider whether the provision of a specific percentage of 20% to define a significant component as opposed to the auditor's judgment based on circumstances is appropriate;
- Consider the impact of the proposals in Proposed Revised ISA 600 on small practitioners and the audit of small entities;
- Consider whether there should be a threshold measure of the work on the group that the principal auditor must perform or be involved in, and to consider such threshold both when responsibility is divided and when the principal auditor takes full responsibility;
- Address strengthening U.S. guidance for group audits when the principal auditor assumes full responsibility, consistent with the provisions of Proposed Revised ISA 600; and

Clarify the concepts of related and unrelated auditor when revising the U.S. standard.

4. AT 501 & SAS 60

The Internal Control Task Force is revising AT 501, which would be directed at non issuers, to reflect certain definitions and related guidance in Public Company Accounting Oversight Board Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*. Michael Umscheid, chair of the task force, led the ASB in a discussion of a revised draft of AT 501. The ASB:

- Discussed (1) whether an entity's financial statements must be audited for a practitioner to perform an examination of its internal control; (2) whether these two engagements must be performed by the same practitioner; and, (3) what the extent of the communication should be between the two practitioners, if they each perform one of these engagements. The ASB noted that:
 - Ideally, an examination of internal control should be performed for the same period covered by the audit of the financial statements, and the two engagements should be performed by the same practitioner.
 - Many control weaknesses are identified when performing substantive procedures during the financial statement audit.
 - There may be instances when a different practitioner may have to perform one of the engagements.
 - If a full financial statement audit is not performed, at least some substantive testing should be performed.

- Instructed the task force to consider the level of communication and cooperation that would be needed between two practitioners if they each performed one of the engagements.
- Noted that there is a need for a companion document that provides guidance for situations in which a practitioner performs both engagements (an integrated audit)
- Indicated that further clarification is needed regarding the distinction between the terms *significant* and *material* in the April 2005 draft of AT 501. Since materiality can be qualitative or quantitative, it is still not clear as to how “significant” differs from “material.”
- Concluded that a practitioner would not omit performing tests of controls related to material accounts if the risk related to qualitative factors was low. Instead, the practitioner might vary the types of procedures performed. (It was noted that the PCAOB will be issuing interpretive guidance on this topic.)
- Discussed the topic of “rotation” of tests of controls from period to period and concluded that the term “rotation” is inaccurate. Instead, the auditor considers information derived from procedures performed in prior periods as well as current information, walkthroughs, and risk assessment to determine the nature, timing, and extent of testing to be performed.
- Requested that the task force consider providing examples of how testing might vary based on these factors.
- Concluded that the rules, in paragraph 133 of the April 2005 draft, for determining whether a practitioner may alter the nature, timing, and extent of procedures from period to period are somewhat restrictive and do not reflect a risk based approach.
- Was divided as to whether management should be required to make its assertion public, for example, by attaching it to the practitioner’s report. Another option would be to require that management’s assertion only be included in the representation letter.
- Directed the task force to provide additional guidance as to what would need to be included in management’s assertion.
- Was divided as to whether an entity’s comprehensive “monitoring” of the other four elements of internal control (control environment, risk assessment, control activities, and information and communication), and documentation of that monitoring provides management with sufficient evidence to make an assertion about the effectiveness of internal control.

The task force will bring a revised draft of AT 501 to the July 2005 ASB meeting

SAS No. 60

The Internal Control Task Force is revising Statement on Auditing Standards (SAS) No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, to reflect certain definitions and related guidance, relevant to nonissuers, in Public Company Accounting Oversight Board Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, (AS2). Michael Umscheid, chair of the task force, led the ASB in a discussion of a revised draft of the SAS. The ASB:

- Discussed whether the word “external” to describe the users of the financial statements (“external users”) or the purpose of the financial statements (“for external purposes”) was meaningful in the context of the financial statements of nonissuers.
- Discussed the possible effects on the auditor’s report when management is unable to, or requests the auditor to draft the financial statements.
 - Noted that AICPA independence standards enable a CPA to draft financial statements and retain independence if certain criteria are met, for example, the CPA may not authorize or approve transactions for the client. The evaluation of the CPA’s independence is made separately from the evaluation of control deficiencies.
 - Agreed that in evaluating control deficiencies, the auditor should use professional judgment in determining whether the client has appropriate controls over the preparation of financial statements.
 - Agreed to delete paragraph 14 of the proposed SAS which addresses financial statements drafted by the auditor.
- Agreed that the definitions of *significant deficiency* and *material weakness* in proposed SAS No. 60 should be conformed to those in AS 2.
- Agreed that control deficiencies noted by the auditor that are considered to be significant deficiencies or material weaknesses should be reported in writing to management and those charged with governance.
- Noted that report users might erroneously conclude that the auditor’s communication regarding control deficiencies is also applicable to interim periods; suggested that language be added to the report to clarify this matter.

The task force will bring a revised draft of the proposed SAS to the July 2005 ASB meeting.

5. SAS 69

The staff presented a proposed Statement on Auditing Standards (SAS), *The Meaning of Presents Fairly in Conformity with Generally Accepted Accounting Principles – Amendment of SAS 69 for Nongovernmental Entities* that would amend SAS 69, *The Meaning of Presents Fairly in Conformity with Generally Accepted Accounting Principles* (AICPA, *Professional Standards*, vol. 1 AU sec. 411). The proposed SAS is in response to the April 28, 2005, Financial Accounting Standards Board (FASB) exposure draft of a Proposed Statement of Financial Accounting Standards, *The Hierarchy of Generally Accepted Accounting Principles*. In its exposure draft, the FASB carries forward the GAAP hierarchy as set forth in SAS 69, with certain modifications—essentially moving the GAAP Hierarchy for nongovernmental entities from the auditing literature to the accounting literature.

The ASB directed the staff to modify the proposed SAS to remove the GAAP hierarchy for nongovernmental entities from SAS 69. The SAS should refer to the FASB literature as the source of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in accordance with GAAP.

The ASB voted in favor of a ballot to issue this proposed SAS for exposure. The comment period will end on June 27, 2005.

6. Management Representations

Mr. Newton, chair of the Management Representations Task Force, led a discussion of the IAASB proposals to revise ISA 580, *Management Representations*. The Task Force is charged with revising SAS No. 85, *Management Representations*, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 333).

A revised issues paper is expected to be presented to the IAASB in June 2005, and the ASB will receive an updated report at its July 2005 meeting.

7. Auditor's Report

Mr. Monk, chair of the Auditor's Report Task Force, presented this matter to the ASB. The Task Force is charged with revising SAS No. 58, *Reports on Audited Financial Statements*, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 508). Mr. Monk discussed the issues raised by the task force. The ASB:

- a. Confirmed that the audit of a single financial statement should remain within the scope of the revision of SAS 58;
- b. Directed the task force to continue to pursue the user's responsibility language;
- c. Agreed that the date of the auditor's report should be the date on which the auditor has sufficient appropriate audit evidence on which to base his or her opinion, and that sufficient appropriate audit evidence includes evidence that the entity's complete set of financial statements has been prepared and that those with

- the recognized authority have asserted that they have taken responsibility for them;
- d. Retain language in the auditor's report that is consistent with International Standard on Auditing 700 (Revised), *The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements*. The summary to the exposure draft should ask respondents what they believe the word "considers" means in the context of the phrase "the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances;" and
 - e. Agreed with the task force's proposal to refer to the relevant sections of the professional standards for guidance with respect to supplementary information

8. Communications

Mr. Montgomery, chair of the Communications Task Force, presented this matter to the ASB. The Task Force is charged with revising SAS No. 61, *Communication with Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), as amended. Mr. Montgomery summarized the key issues related to harmonization of proposed (Revised) ISA 260, *The Auditor's Communication with Those Charged with Governance*, with SAS No. 61. In response to Mr. Montgomery's presentation, the ASB recommended that the task force:

- Emphasize, in the revised SAS, that communication to those charged with governance concerning the planned scope and timing of the audit be at a reasonably high level, and that the communication regarding materiality focus on the factors to be considered rather than on amounts or thresholds.
- Not include a requirement that the auditor communicate information regarding his or her independence
- Consider the scope of the requirement in the ISA that the auditor communicate matters that are "serious and relevant to the responsibilities of those charged with governance."
- Indicate that communication should be a two-way process between the auditor and those charged with governance but not require the auditor to assess the effectiveness of the two-way process
- Consider which provisions of the SAS would apply if many or all of those charged with governance are involved in managing the entity.

The task force will present a draft of the proposed SAS at the July 2005 ASB meeting.

9. Estimates

Mr. Harold Monk, chair of the estimates task force (task force), led a discussion of the background and the status of the estimates project.

Background

In December 2004, the IAASB approved for exposure (exposure period ended April 30, 2005) Proposed [ISA 540 \(Revised\), Auditing Accounting Estimates and Related Disclosures \(Other than Those Involving Fair Value Measurements and Disclosures\)](#). The objectives of the exposure draft are to (1) introduce requirements for greater rigor and skepticism into the audit of accounting estimates, including the auditor's consideration of indicators of possible management bias; and (2) conform the approach taken to the audit of accounting estimates with the revised audit risk and fraud standards issued by the IAASB.

Status

Mr. Monk reported that the task force met on April 4, 2005 and April 20, 2005 via conference call to discuss proposed ISA 540 and to identify issues for discussion. Issues identified were:

1. *Known vs. Likely*—Paragraph 68 of the proposed ISA defines known misstatements involving subjective decisions as “differences between management’s and the auditor’s judgment concerning the reasonableness of accounting estimates, in the context of the applicable financial reporting framework.” This definition is the same as the definition in paragraph 46 of Proposed ISA 320, *Materiality in the Identification and Evaluation of Misstatements* which was part of the risk assessment project. Proposed ISA 320 addresses evaluating audit differences, including those involving estimates. At issue is whether the task force agrees with the classification of audit differences involving estimates as known misstatements instead of likely misstatements. In reviewing the proposed SAS, *Audit Risk and Materiality*, which is the U.S. counterpart of Proposed ISA 320, the risk assessment task force’s view is that such audit differences should be treated as likely misstatements. This is because the auditor’s procedures often yield imprecise amounts to test the reasonableness of management’s estimate and in a time when known misstatements are encouraged to be booked, this would have the illogical consequence that the financial statements would reflect a less precise amount.
2. *Point Estimate*—Paragraph 69 similarly concludes that a difference between management’s point estimate and the auditor’s point estimate should be classified as a known misstatement—misstatements involving subjective decisions. The risk assessment task force’s position is that a point estimate is nevertheless an estimate and unless it is precisely determined, differences between management and the auditor involving point estimates should be classified as likely misstatements and not as known misstatements.

See risk assessment’s highlights for discussion and resolution of issues 1 and 2 mentioned above.

3. *Retrospective Review*—Paragraphs 20-22 require auditors to ‘look back’ at accounting estimates recorded by management in the prior period to assess

management's estimation ability. The task force suggests that more guidance be provided in this area to assist auditors.

4. *Range in Excess of Materiality*—Paragraph 79 states the following:

Where an accounting estimate falls within a reasonable range of outcomes that is greater than materiality, the auditor should determine whether the applicable financial reporting framework requires disclosure of the estimation uncertainty and, if so, evaluate the adequacy of such disclosure.

The task force recognizes that this requirement may apply elsewhere internationally. But, domestically, this requirement seems to be problematic. The task force questioned the auditor's ability to audit a disclosure (and thereby issue an unqualified opinion) wherein management's estimate would be so uncertain that the possible range exceeds materiality.

After discussion, the ASB agreed that these issues merit further discussion.

In addition, the ASB directed the task force to consider the following matters:

1. Assess whether the proposed ISA, as written, is responsive to the needs of smaller firms.
2. Compare the materiality guidance on this proposed ISA to Statement on Auditing Standards 101, *Auditing Fair Value Measurements and Disclosures*.
3. Consider the issue of the impact on the auditor's report of significant estimates, that is, whether an emphasis of the matter would be useful in cases when the range of estimates disclosed by management exceeds materiality.

10. Related Parties

Mr. Fritz, Chair of the Auditing Related Party Transactions Task Force (the "Task Force") lead a discussion of the issues with respect to a proposed revision of AU section 334, *Related Parties*. The discussion included the status of the related International Auditing and Assurance Standards Board's project and the Task Force's initial observations with respect to the proposed revision to International Standard on Auditing 550, *Related Parties* (the "ISA"). With respect to the draft proposed ISA, the Task Force expects to discuss the following aspects of the draft:

- Structure, including length. The draft ISA is structured around the ISA's risk assessment standards. The Auditing Standards Board discussed whether it is appropriate to follow a risk-based approach in auditing related parties and related party transactions. The Task Force will discuss the structure of the proposed ISA and whether the apparently complex and repetitive approach provides effective guidance.

- That the draft proposed ISA does not address the related accounting considerations
- Scope
- That the draft proposed ISA does not discourage disclosures of arms-length assertions about related party transactions, though it does require that management substantiate any such assertions and that the auditor obtain sufficient evidence that the assertions are substantiated
- That the draft proposed ISA requires written representations from management (and perhaps those in governance) regarding the completeness, accuracy, and adequacy of related party disclosures
- That the draft proposed ISA does not specifically address communication of related parties to audit personnel performing segments of the audit

The ASB discussed the issue raised by the Task Force's initial review of the draft proposed ISA. The Task Force is scheduled to meet on May 20, 2005, at which time a revised draft proposed ISA is expected to be available. The Task Force will discuss that revised document at its meeting.

Appendix

Risk Assessment Project Background Information

On December 2, 2002 the ASB issued an exposure draft of a suite of seven proposed Statements on Auditing Standards (SASs) relating to the auditor's risk assessment process. The exposure draft consists of the following proposed SASs:

- *Amendment to Statement on Auditing Standards No. 95, Generally Accepted Auditing Standards*
- *Audit Evidence*, which would supersede SAS No. 31, *Evidential Matter* (AU sec. 326)
- *Audit Risk and Materiality in Conducting an Audit*, which would supersede SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU sec. 312)
- *Planning and Supervision*, which would supersede "Appointment of the Independent Auditor" (AU sec. 310), and SAS No. 22, *Planning and Supervision* (AU sec. 311)
- *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (Assessing Risks)*
- *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, which would supersede SAS No. 45, *Substantive Tests Prior to the Balance-Sheet Date* (AU sec. 313), and, together with the proposed SAS *Assessing Risks* would supersede SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AU sec. 319)
- *Amendment to SAS No. 39, Audit Sampling*

In October 2003, the IAASB completed the international phase of the risk-assessment project by issuing the following three International Standards on Auditing (ISA):

- ISA 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- ISA 330, *The Auditor's Procedures in Response to Assessed Risks*
- ISA 500, *Audit Evidence*.

In June 2004, the IAASB issued ISA 300 (revised), *Planning an Audit of Financial Statements*. In addition, on December 20, 2004, the IAASB has approved the issuance of the proposed exposure draft ISA 320 (revised), *Materiality in the Identification and Evaluation of Misstatements*.